

Volatile times call for best D&O coverage

Dangerous scenarios can play out, so don't be complacent about your protection.

BY EVAN ROSENBERG

FOR DIRECTORS, the past few years may have been the best of times. But could the worst of times be lurking just around the corner?

Two independent consulting firms, Cornerstone Research and NERA Economic Consulting, both report a significant increase — to levels not seen since 2004 — in securities class action (SCA) filings in the second half of 2007. NERA counts 207 filings in 2007, up from 131 in 2006. Furthermore, the severity of directors and officers (D&O) lawsuits continues to rise, with NERA noting that securities lawsuit settlements averaged \$33.2 million for 2007 — an all-time high and 46 percent higher than 2006.

This spike in securities litigation raises several questions for those who purchase D&O liability insurance coverage. Will the recent decline in D&O liability insurance premiums continue? More importantly, as a director, will your D&O coverage perform the way you need it to?

Stormy days ahead?

D&O liability insurance premiums have declined by nearly 37 percent since 2004, according to consulting firm Tillinghast. This decline in rates directly relates to the previously mentioned lull in securities lawsuits (although it is worth noting that the *severity* of lawsuits continued to increase).

Two predominant theories explaining the lull were forwarded in mid-2007 by Cornerstone Research. According to the

“less fraud” theory, corporate reforms stemming from the Sarbanes-Oxley Act of 2002 have had the desired affect of reducing fraud, resulting in less litigation and a permanent shift to a lower level of litigation. Another possible cause for the decline in SCAs was the increase in options backdating cases, the vast majority of which were brought as derivative lawsuits, and which may have served to “distract” the plaintiff’s bar from filing SCAs. Several of these cases settled for more than \$50 million.



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As my colleague Randy Hein correctly predicted in his article, “D&O Liability: Is This the Calm Before the Storm?” (*Directors & Boards*, Fourth Quarter 2007): “It’s simply unrealistic to assume that the calm will continue indefinitely and that volatility has permanently disappeared from the marketplace. The only truly permanent condition is the potential to be sued.” Since penning those words, the financial world has displayed a great deal of volatility.

Therefore, it is a certainty that the downward D&O pricing trend will at least stabilize as securities lawsuits climb back to “normal,” historic levels. In fact, the banking and homebuilding sectors already are seeing significant rate increases.

During these financially fickle times, it is critical that your D&O policy performs when you need it most. However, if there are criminal or regulatory actions pending against individuals in addition to an SCA, and the limits of the

policy are consumed by defense costs (with hourly fees now exceeding \$1,000 per hour for some top-tier law firms), individual directors and officers can be left without coverage. A case in point is the 2007 Just for Feet Inc. settlement, in which five former outside directors had to pay \$41.5 million.

Or, another equally dangerous (to you) scenario can play out. Suppose your firm’s D&O insurer attempts to capitalize on the recent period of declining premiums and reduces policy prices to win market share. A sudden spike in D&O claims could leave the insurer unable or unwilling to meet its financial obligations to its customers.

In simplest terms, the lesson is “You get what you pay for.” If price is your company’s primary reason for purchasing a D&O liability insurance policy, consider that a red flag. It is important to take other factors into consideration, such as the policy’s coverage terms and the insurer’s financial strength, reputation for service, and expertise in managing D&O claims.

A good time for ‘Side A’

This leads me to one final, critical point. If you don’t already have “Side A” D&O liability insurance coverage — which offers protection dedicated to individual directors and officers for nonindemnifiable loss — now is the time to consider purchasing it. The credit crisis and an increasingly volatile stock market heighten your personal risk as a director.

Consider this: Your personal assets are at risk if your company becomes financially insolvent and is unable to indemnify a claim against you; your company simply refuses to indemnify; or if the law prevents your company from indemnifying you. You may want to consider consulting with an attorney or trusted adviser to discuss your individual situation. “Side A” coverage from an experienced insurance partner may be one way to help protect you from the storm clouds gathering overhead. ■

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